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RAILROAD OVER-CAPITALIZATION

SUMMARY

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Over-capitalization, which may be defined as an excessive issue of securities in proportion to the physical assets, seems to be associated dynamically with six phases of railroad finance. In other words, no fewer than six particular occasions present themselves as opportune for inflation of capital issues. These arise: in connection with construction; through replacement of property; by division of accumulated surplus; as a concomitant of refunding; as an incident of consolida-

tion; and, finally, as a feature of financial reorganization. The provision of entirely new capital directly affords opportunity, of course, for an undue issuance of shares or bonds. But this subject is so extended in its ramifications as to require treatment by itself. With this exception, it is believed that the above-stated scheme of classification comprehends practically all phases of over-capitalization.

(1) The importance of construction as inviting an over-issuance of securities is emphasized by the proposition pending in Congress to so enlarge the jurisdiction of the Interstate Commerce Commission as to include all operations and accounts of construction companies along with operating railroads. The need of wider authority has been brought to public attention by a number of recent scandals, particularly those of the St. Paul Pacific coast (Puget Sound) extension and of the St. Louis and San Francisco.[1] A large body of experience, dating from the earliest days of railroading, has clearly proven the imminence of financial excess in this connection. The persistence of these practices is well exemplified also, altho on a small scale, in a number of recent cases before the state railroad commissions.[2]

(2) The capitalization of expenditures for replacement of property which ought to have been paid for from income is probably one of the most common corporate errors of the time.[3] Improper manipulation of betterment and maintenance accounts leads readily and immediately to the augmentation of capitalization with-

1 These and a number of others are discussed *in extenso* by the author in the Railway Age Gazette, vol. lvi, 1914, pp. 1177 and 1225.

2 Nebraska Railway Commission, 6th Ann. Rep., 1913, p. 255; and P. S. C., Missouri, vol. i, 1913, p. 141.

3 Cf. P. S. C., New York, 2d D., 1910, vol. i, p. 132.

out a corresponding investment of new funds. The intricacy of the subject is manifested by the case of the Kansas City Southern before the Supreme Court of the United States in 1913.[1] The company desired to pay for the entire cost of a much better re-location of a part of its main line from the proceeds of a bond issue, without any deduction whatsoever for the cost or value of the old bit of line which was abandoned. This was defended on the ground that operating expenses would be so substantially reduced in consequence of the re-location as to fully support the enhanced interest charges. Both the Interstate Commerce Commission and the Supreme Court held, however, that such action amounted virtually to the payment of dividends from capital. For, the argument continued, all dividends or interest upon the securities originally issued to pay for the old line, if continued, evidently imposed two burdens upon present earnings; those, namely, associated both with the original and with the new investment. The government also made the valid plea that it was really the first investment which alone made the second one possible. This the company denied, alleging that the reduced operating expenses would fully offset the larger fixed charges.[2]

The boundary line is indeed vague between mere neglect to differentiate income from capital, and downright deception of others in this regard. Expenditures may be capitalized, not for real betterments, but for pretended ones which ought to be paid for from earnings.

[1] 231 U. S. 423.

[2] Cf. Ripley, Railroads: Rates and Regulation, p. 67. In this connection an ingenious argument against the American practice of charging betterments to income account may be mentioned. It is to the effect that capital outlay is at least subject to a greater degree of publicity than revenue expenditure; and consequently that deceptive or speculative action is more likely to be thwarted. The argument naturally has no force under our present American *régime* of governmentally standardized accounting. See McDermott, Railways.

Real improvements may be paid for in excess of their actual value. Or, even worse, current expenses in the form of bills payable, wages and supplies may be met by issues of interest-bearing script. Floating debt may be allowed to accumulate in paying current expenses, while dividends which ought to have been cut off continue to be paid; and then this floating debt may be refunded into permanent securities. Is it not clear that in each instance, capitalization is expanded unduly in proportion to the actual worth of the property? Such things are usually done so as to disguise the facts. But however details may vary, the principle is fundamentally the same. The resources of the future are improperly exhausted for the benefit of the present.

Failure to charge replacement outgo to income rather than capital account has accompanied recently the financial distress of two important roads. Both affairs were deceptive in the extreme, — on the Rock Island wilfully and perhaps even fraudulently so, while on the Boston & Maine the mistaken policy seems to have been due rather to ignorance, neglect or inefficiency. The facts as to the Rock Island were brought to light in 1914 in connection with reorganization proceedings. After the management had issued a highly encouraging statement indicating a liberal upkeep of roadbed and equipment for 1913, an expert investigated the matter from another angle for the bondholders.[1] He reported a corporate starvation policy so extreme that about 20,000, — that is to say, one-half, — of the company's freight cars were worn out and should be retired at a cost for replacement of $15,000,000; also that inadequate or, as it was termed, "deferred maintenance work" would necessitate another $8,000,000 expenditure. These two items alone transformed a reported surplus of $13,600,-

[1] Report by Vice-President McKenna, of the St. Paul, May, 1914.

000 for the preceding year into a profit and loss deficit of $10,291,000. Obviously the only way to save the property was to capitalize this deficit at once by an assessment upon security holders. A similar experience, this, to the Atchison and the Baltimore & Ohio twenty years before, repeated almost word for word!

The complete collapse of the Boston & Maine Railroad in 1913 affords a second recent instance of the penalty imposed by years of self-deception in matters of replacement and depreciation.[1] Large sums which under the dictates of ordinary intelligence and prudence ought to have been invested in the property from earnings were for years diverted to the payment of excessive dividends, — not absolutely excessive in the sense of affording an unreasonable return on the capital, but relatively so, in the sense that they brought about a progressive impoverishment of the road. Such deceptive financiering need not necessarily be in the nature of a fraud upon stockholders, however great the losses which they may be called upon to bear through having innocently dissipated their capital thinking they were merely spending their income. Undoubtedly it has thriven in the past upon the pretended need of secrecy in the matter of accounts. From the public point of view, in the last analysis it invariably entails an undue burden of securities upon the shoulders of the community to be supported out of current earnings, while at the same time exposing patrons to the exasperation of a halting, unsafe and inadequate service. The primary lesson to be learned by railroad managements is that, not more than current earnings but at all times far less, should be distributed in the way of dividends. The moral for the public is that it must be prepared to countenance such rates as shall yield, not only regular normal rates of

[1] 27 I. C. C. Rep. 593; cf. p. 622, infra.

return upon capital but a substantial sum in addition to provide for future contingencies, especially the "costs of progress." [1]

(3) Relief from the embarrassment of an exuberant surplus by means of extra cash or stock dividends is a simple operation. But corporate surpluses are by no means confined to ready cash, quick capital, or marketable assets. A profit and loss account merely evens up the difference between assets and liabilities on the balance sheet. A surplus seems substantial enough; but in reality it is a hazy and elusive thing. In the first place it depends entirely upon the particular valuation placed upon the assets. A stroke of the pen in writing off property account may serve to obliterate it entirely. But even if the valuation of assets be sound, the surplus may be a fictitious one. A large part of it, instead of being a cash fund or convertible securities, may be a mere statement of past earnings appropriated to a future use, and in the meantime inextricably entangled in the business. As thus invested it is subject to the same risk of obsolescence or depreciation as the rest of the plant. It may not even be property at all but merely reputation, built up by heavy expenditures for advertising and the like.[2] Such a surplus may indeed prove in time of trouble to be a weak reed instead of a staff. The Western Union when taken over by the American Telephone Company had its surplus of $18,800,000 promptly written off by more than two-thirds. The Illinois Central, too, acted the part of prudence a few years ago in transferring its "dividend reserve fund" to profit and loss; perceiving that, altho theoretically

[1] P. 609, infra.

[2] Cf. the New Jersey cases authorizing capitalization of development expenses. P. S. C., 1912, p. 246.

such a fund might be drawn upon to eke out dividends, in fact it was a mere book statement not serviceable at all when needed. And the Missouri Pacific, upon emerging from unintelligent Gould management, found it wise to eliminate a lot of dead wood from its surplus account. Nevertheless, a surplus representing undistributed earnings over a term of years may sometimes under conservative administration attain large proportions. And it may well be that by the growth of assets in this way, the property has reached a condition of acute under-capitalization. The temptation under such circumstances to reimburse the treasury of the company for such uncapitalized outlay, and thereby to reëstablish an equivalence between assets and outstanding securities, may become at once irresistible and venial.

There are a number of ways by which undivided earnings may be capitalized, other than by means of either cash or stock dividends. The Villard administration of the Northern Pacific in 1888, just on the eve of bankruptcy, shifted accumulated charges of improvements to income through a number of years over to capital account; and an attempt was then made to sell securities in order to balance the books. But it failed to accomplish what the Alton management in 1898 so successfully performed for the benefit of "insiders." Under happier auspices the Union Pacific in 1914 seems about to distribute its surplus to common stockholders, in the form of a donation of $82,000,000 of Baltimore and Ohio stock from its treasury, — stock which it had received in exchange for its speculative investments in the shares of other companies.[1] Ostensibly this "plum" was a distribution of profits not resulting from transportation at all but accruing from successful financial opera-

[1] Validated by N. Y. Court of Appeals decision, July 15, 1914, declaring that $15,000,000 profit on conversion of stocks and $38,000,000 on stock market operations in Northern Pacific, etc., were profits not capital.

tions since 1900. It would appear as if the public interest were not concerned, inasmuch as the outcome was a profitable one. But suppose the speculation had failed? Would not the road have been impoverished to that degree, with necessary deterioration of service? Nor is that all. Collateral trust bonds were originally issued to acquire many of these stocks. They were generally convertible, to be sure, so that fixed charges became largely transformed into contingent ones. But the fact is indisputable that this one-time indebtedness, now transmuted into capital stock,[1] remains outstanding as an absorbent of future earnings; altho the assets which it once served to purchase have been handed over to stockholders as a gratuity. That the surplus earnings from past years still undistributed, together with the increment in the value of tangible property, notably land, preserved an equivalence of assets and liabilities on the books even after the withdrawal of this huge bonus, obscures but does not alter the fact that the distribution is at bottom "affected with a public interest."

American railways have liberally utilized surplus earnings to build up their properties. The Pennsylvania Railroad for years adopted the "dollar for dollar" practice of devoting literally one-half of its income to reinvestment in the plant. During 1887–1911 the sum of $262,000,000 was put back into the Pennsylvania lines east of Pittsburgh from earnings, — an amount, that is to say, nearly equal to two-thirds of the total cost of construction of its 2000 odd miles of line.[2] The Chicago & Northwestern in like manner during the twenty year period to 1913 so divided up its net income of $200,800,000, that $77,700,000 of this amount re-

[1] Even altho the dividend rate is reduced from 10 to 8 per cent coincidently with the distribution of assets.

[2] 20 I. C. C. Rep. 243. Even during the decade to 1913, out of $530,000,000 added to property investment, $164,000,000 came from undistributed earnings.

mained undistributed either in the form of direct appropriation from earnings for improvements, or of income carried to surplus account. In the South, the Louisville and Nashville in the eight years before 1907 put back into its plant over $18,000,000 of undivided earnings — equal to over 30 per cent of its share capital. The total surplus thus built up in 1912 is said to have amounted to upwards of 90 per cent of its entire capital stock. The opinion in the Western Rate Advance case [1] of 1910 stated that the unappropriated surplus of all the railroads in the United States at that time amounted to $800,642,923; of which $606,500,000 had been accumulated in the ten years to 1909. Such facts are impressive. They certainly do not fairly represent recent tendencies, since 1909. Surpluses of this sort are not now being heaped up. But they indicate how important the question of the interest of the public in such surplus earnings may at times become.

The fact of the existence of substantial surpluses, arising partly as a result of our conservative American practice of putting a portion of earnings back into the property and partly as a result of the exceptionally rapid development of the country, naturally gives rise to the question as to how far the public has an equitable interest therein.[2] The rate-making aspect of the matter has already been considered in connection with physical valuation.[3] The question in so far as it touches the regulation of capitalization must be approached somewhat differently.[4] In practice the issue generally arises

[1] 20 I. C. C. Rep. 243.

[2] Well discussed by J. H. Gray, The Economic Review, vol. iv, supp., 1914, p. 36; by L. G. McPherson, Railway Age Gazette, vol. liv, 1913, p. 1118; and in Whitten, Valuation of Public Service Corporations, 1912, pp. 176–189.

[3] Political Science Quarterly, xxii, p. 907, p. 599.

[4] Various differences in principle regarding the determination of a reasonable basis for capitalization and for rate-making obtain. One depends upon local accounting practice and state regulation of capitalization; the other, most rates being interstate,

over the right of the railroad to distribute its surplus in stock or cash dividends. Two clearly defined and opposing views are discernible. The older and simpler one is that stockholders have an inalienable right to all earnings of the company; and that if they choose to permit a portion of current income to remain invested in the property, they in no wise forego thereby their right to take it over to themselves without interference at any future time. Such a view was well expressed by the management of the Great Northern when in 1883 it made an extra distribution in the shape of an issue of $10,000,000 of bonds, " payable 10 per cent in cash and 90 per cent in property, constructed or acquired with stockholders' money, — thus returning to them $9,000,-000 in the nature of a forced loan taken from them by sequestration of $11,000,000 of profits during previous years." In confirmation of this view, it deserves to be kept in mind that until a comparatively recent date, there was nothing in the charters of railways, in state constitutions, or in the law of public service callings, to indicate that investments by railways from earnings would be differently treated from investment by direct subscription of shareholders. This point has often been raised in connection with the inclusion of surplus earnings in the " fair value " of the property for rate-making purposes. To decline so to do might lead to absurd results. For otherwise, as between two railroads of different earning power, each pursuing the policy of reinvesting one-half its income in the plant,

is largely a Federal concern. The treatment of obsolescence or misplaced investment is also different. Market value may be a standard for capitalization, but seldom for rates. Under physical valuation, cost of reproduction may be applied in rate-making, but original cost or investment should be used for capitalization, assuming that the increment of land valuations, as in Texas, is excluded. Most physical valuations and cases before administrative commissions have had to do with rate-making ; but the Massachusetts Validation Commission of 1911, the Third Avenue Street Railway case in New York, and some judicial decisions are mainly concerned with sound capitalization.

the more profitable one, altho it might upbuild its property hugely by comparison with the other, would not be permitted to enjoy the fruits of its self-denial in any corresponding degree. A penalty upon prudence and thrift would surely be imposed.

The other view, which upholds the claim of the public to substantial enjoyment of the surplus of public service corporations, has been freely expressed in recent rate cases. Oddly enough, judicial decisions throw little light upon it. The argument is well put by Whitten as follows:

> If a company has charged rates, not alone adequate to pay a fair and reasonable profit to the stockholders, but also to permit the building out of earnings of extensions and improvements aggregating as much as the total investment of the security holders, there is some justice in the argument that unless this has been done for the benefit of the consumers it represents pure extortion. Profits in excess of a fair return should either be distributed to the consumer in lower rates, or if used for extensions and improvements, should be deemed to be held in trust for the exclusive benefit of the consumer.

Nor is this all that may be urged in the public behalf. To permit a railroad to capitalize its surplus earnings fully, it is said, and thereafter to permit it to enjoy a return upon this additional investment is, in fact, to permit the shareholders to have their cake and to eat it too;[1] or, in other words, to make the patron pay more in the future, and forever, because he had already paid an unreasonably high rate to create the surplus in the past.

Our own decision in the matter is intermediate between the two extremes of opinion above stated. In the first place, a just decision will depend upon circumstances, particularly upon the actual source of the surplus itself. An appreciable part of it may be due to the

[1] Precisely the line of reasoning in a Lehigh Valley rate case; 21 I. C. C. Rep. 160.

growth of land values.[1] In the Western Rate Advance case of 1910 the Burlington road claimed a total valuation of $530,000,000 according to which its surplus amounted to $272,000,000. The Commission found in turn that $150,000,000 of this latter sum was due to the increment in real estate, while only $122,000,000 represented property acquired out of earnings.[2] Another instance in the South is afforded by the Atlanta & West Point in Georgia. Reinvestment of all earnings in the plant for many years, but particularly the enhanced value of terminal property in Atlanta, seemed fully to warrant doubling the capital stock in 1910 and basing earnings and rates thereupon.[3] An additional complication, of course, is that not infrequently there may have been large grants in aid of construction originally made for nothing. This must also be taken in account.[4] An entirely different problem is presented by the surplus distributed by the Union Pacific in 1914, — a surplus resulting from successful speculation in the stocks of other railroads.

Decision should be made also in the light of the general conditions prevailing at the time. A generation ago it was the common practice to divide all profits in sight and to finance new construction by the issue of securities. Such policies were fully sanctioned by the public opinion of the day. But a few roads, undoubtedly well in advance of their time, during the '80s began to devote a good part of their earnings to new construction and betterment. Without outrage to public opinion much of this at that time might well have been added to dividends. The shareholders' rights in

[1] Cf. Whitten, Valuation, chap. vi.

[2] 20 I. C. C. Rep. 332.

[3] Commissioner Clements in Hearings, I. C. C. Committee, 1912 on H. R. bill 12811, p. 8.

[4] Ripley, Railroad Valuation, Political Science Quarterly, vol. xxii, 1907, p. 577.

such a surplus certainly deserve determination in the light of the then-prevalent practice. To apply the standards of the present day when pioneering chances have been supplanted by rate-regulatory risks, would be manifestly unfair. The dilemma is most puzzling in those instances where the source of the surplus has been exceptionally intelligent management, coupled with manifestly fair treatment to the public. Such an issue is presented, as we shall soon see, by certain Massachusetts gas company cases. The sharp differentiation of a surplus thus created, from surpluses arising through public donations or an increment in land values on the one hand, or an extortionate rate policy on the other, is sufficient to discourage loose generalization. In fine each case must be judged upon its own merits.

A sane treatment of property derived from surplus will be found in the policy of the Massachusetts Gas and Electric Light Commission. It is well expressed in the Haverhill Gas Co. case.[1] In this instance a public service company by exceptionally careful and conservative management, coupled with a rapid gain in wealth and population of the community supplied, accumulated a substantial surplus over and above the customary rate of 10 per cent dividends. This conservative policy was encouraged by the Commission on the ground that it insured steady dividends and also resulted in the highest efficiency at low cost. Such a use of surplus, it was held, conferred substantial benefit upon the public and the shareholders alike. It seemed particularly desirable in the '90s in view of the prospective keen competition of electric light with gas. Finally, however, the demand for a reduction of rates on one hand, and for capitalization of this surplus on the other,

[1] 16 Ann. Rep., 1901, p. 9. Cf. also address of F. E. Barker, Convention of R. R. Commissioners, 1913.

brought the matter squarely up for decision. The commission has consistently adhered to its view that by every principle of law such a surplus is the property of the corporation; but, at the same time, that there is imposed upon such a public monopoly "the duty to employ it for the joint advantage of the consumers and the corporation. It need not be dealt with as the exclusive property of either." Unfortunately this admirable theory has been difficult to apply in practice. After fifteen years of litigation, during which the Massachusetts courts have steadily upheld the theory of private property rights, the public in Haverhill has not yet succeeded in securing any reduction in the price of gas. The Supreme Court of the State in 1913, in the similar Fall River case, completely over-ruled the Commission. This body had sought to prevent further issues of stock for extensions while the company at the same time was regularly distributing its surplus in the shape of extra dividends over and above a regular rate of 12 per cent.[1] Such experience tends to confirm the view expressed by Commissioner Prouty [2] as to the practical impossibility of making amends to those who have once paid excessive rates, by laying hold upon such surpluses. Supervision of capitalization, as of rates, must be continuous and fore-seeing, not spasmodic and tardy. Harm must be prevented. Once done, it cannot be corrected. But is the accumulation of a surplus to be regarded, indeed, as a menace? Is it not in fact just the opposite? We shall see.

Somewhat similar points have been recently considered by the Interstate Commerce Commission. In the Spokane case,[3] counsel for the shippers contended that the ample surpluses of the Pacific railroads should

[1] Gray, op. cit., p. 38.

[2] 15 I. C. C. Rep. 415.

[3] 15 I. C. C. Rep. 376, 415.

in some way be distributed by the Commission, acting as a trustee for the public, through a reduction of rates. But it was pointed out in the decision that, under a uniform scheme of rates, one road by reason of cheaper construction or easier operation might pile up a surplus while the other did not. Could it then be said that this surplus had been improperly accumulated so long as its rates had been no higher than those of its competitors? Similarly in the Eastern Rate Advance case in 1911,[1] assent within certain limits was given to the accumulation of surplus in order to provide for necessary improvements which for the time being, or in their nature permanently, did not yield a return. Large investment of a non-productive sort such as passenger stations, the abolition of grade crossings or the installation of safety appliances, may properly be cared for in this way. But, the opinion added, stockholders must also contribute to such surpluses through a reasonable sacrifice in dividends. This was undoubtedly what the Railroad Securities Commission of 1911 had in mind in declaring that surpluses might most fairly be utilized to meet the necessary "costs of progress." An admirable policy, voluntarily adopted by a public service corporation, is that of the American Telephone and Telegraph Company.[2] The directorate set forth the advantages to the company of a large surplus as strengthening credit, assuring steady dividends, procuring new capital on favorable terms, and maintaining a high state of efficiency in operation at low cost. The promise was held forth that such reserves and betterment should not be made the basis in future of larger dividends, but should constitute a trust to be administered in the public interest. These reserves, it was hoped, were to remain as assets "indivisible, inviolable and inalienable," — not,

[1] 20 I. C. C. Rep. 243, 265.

[2] Ann. Rep., 1912.

in other words, at some future time to be divided up among the shareholders. Under such circumstances, the advantage to the public of large reserves, thus invested, is that reduced charges and improvement in service will naturally follow by reason of the economies in operation introduced.[1]

(4) Refunding, as affording an opportunity for surreptitious inflation of the volume of outstanding securities, is of relative unimportance, judging by the experience of our public service commissions. Usually the operation merely perpetuates, it does not create, an undue volume of indebtedness, — allowance being made, of course, for changes in the prevailing rate of interest and the condition of investment demand.[2] The offence, if there were one, was usually committed at the time of the original issue. But the necessity of refunding sometimes affords an opportunity for the intervention of administrative authority to correct a previous over-capitalization in whole or in part. The hard-fought Delaware & Hudson case, outlined in our review of the New York experience,[3] illustrates the manner in which the refunding of floating indebtedness may be critical in the larger affairs of consolidation of railroad properties. In Texas, refunding operations have been of peculiar interest. The Railroad Commission of that state interpreted the law, rigidly restraining all further issues of securities until capitalization had been brought down to the level of property valuation, as prohibiting even the refunding of existing bond issues.[4] The matter became acute about 1905–06, when a large number of

[1] The theory of partnership in surplus is well stated by H. V. Hayes in North American Review, vol. cxcviii, 1913, p. 341. Cf. also his Public Utilities, 1913.

[2] Economic Review, xix, Sept. 1914.

[3] Economic Review, vol. xix, Sept., 1914.

[4] Economic Review, vol. xix, Sept., 1914.

bonds of Texas roads reached maturity. The physical valuations applied by the Commission as a standard of measurement were generally well below the volume of bonds outstanding, to say nothing of the capital stocks; and revaluation was denied on the ground that accounts could readily be kept up to date by adding the yearly reinvestments of income to the original figure. If prohibited from refunding the maturing bonds, dollar for dollar, the roads would be unable to issue enough new ones to take up the old. Enabling legislation to mitigate the rigor of the law was urgently sought but in vain. The only escape for the roads was to issue new bonds to the full amount of their physical valuation and then to leave the balance as a floating debt. To the outsider, it appears as if this policy of excision were unduly severe. If, as in the Delaware and Hudson case, there was evident over-capitalization to be corrected, it seems as if the wiser plan would be to permit refunding, but to insist upon guarantees that the company would make amends within a reasonable time by a gradual process of amortization.[1]

(5) Consolidation of railroad properties offers an exceptionally favorable opportunity to increase capitalization surreptitiously. The English practice of " splitting " securities had its beginnings in connection with merger operations. New classes of stocks known as preferred and deferred shares were put forth, each of them equal in volume to the total original stock outstanding.[2] A prime advantage of consolidation, of

[1] Certifications of refunding operations by other state commissions are given in the Economic Review, vol. xix, Sept., 1914. Even later ones approved by public authority will be found in the following cases: permitting the St. Paul to exchange $470,000,000 of its own bonds for those of the St. Paul extension, P. S. C., Missouri, vol. i, 1913, p. 305; and prescribing the terms of exchange, discount, etc., of $28,000,000 of Iron Mountain bonds, ibid., p. 105.

[2] McDermott, Railways, p. 164.

course, is that the constituent companies may be so gerrymandered that successful ones with surplus earnings may average their rate of return downward by combination with other properties less favorably situated. A weak corporation, whose stock is quoted say at $50, may be merged in a second corporation whose stock is worth $150 per share. The latter may then issue new stock of its own in exchange for the $50 stock, share for share. Such an operation as this may not only deceive the public, by establishing a fictitious capitalization far in excess of the worth of the investment, but it may also constitute a fraud upon the shareholders of the more prosperous company by diluting the value of their holdings. In ordinary offerings of new shares at favored prices, the stockholder finds compensation for the fall in the value of his shares in the bonus or "right" which he receives. But in these cases of consolidation, the bonuses or rights may go to the favored holders of shares in the weaker company alone. It is conceivable of course, that advantage may flow to both concerns from the merger, particularly through the extension of the credit of the stronger to enable the weaker one to make the expenditures necessary to bring about reduced operating costs. This has been done of late by parent roads outside Texas to subsidiaries therein, subject to the drastic limitations of the Stock and Bond law.[1]

In Texas the details of all railroad mergers of this sort are most rigidly scrutinized, in order to prevent such an increased capitalization. Mere consolidation of roads in the Missouri, Kansas & Texas system in 1891, for example, increased the aggregate of stock and bonds

[1] The analogy with electric lighting properties is imperfect, inasmuch as the latter may concentrate all operation in the stronger plant, while in the case of railways both must still operate in their respective territories. Economic Review, xix, Sept., 1914.

by $12,475,000, or $19,207 per mile of road. This, it will be noted, was before the enactment of the Stock and Bond law.[1] Whether the public interest is prejudicially affected in such cases or not would seem to be dependent largely upon whether the companies absorbed were worth the price paid for them; or, in other words, whether efficiency and earning power were promoted in a degree suitably proportioned to the enhanced capitalization. And, even so, the expediency in the public interest of requiring amortization of the increase in capitalization, as required by the best modern practice, is obvious.[2]

All previous demonstrations of the evil of dilution of capitalization as a concomitant of consolidation are eclipsed by the recent prostration of the once substantial New York, New Haven and Hartford Railroad. Within nine years to 1912, the outstanding securities of this company increased from $93,000,000 to $417,000,000, altho the operated railroad mileage increased only fifty miles.[1] Issues of new stocks and bonds during this period brought in about $340,000,000. Of this sum, $40,000,000 was spent for the purchase of lines previously operated under lease or otherwise indirectly. For betterments and equipment, $96,000,000 was expended. This left a sum of about $204,000,000 which in nine years was invested in properties outside its own

[1] Report of the Railroad Commission to the Governor on the subject of mergers, Nov. 5, 1904; reprinted in full in the Dallas News of Nov. 27, 1905.

[2] Cf. New York Public Service Commission practice, reviewed by the author in Economic Review, Sept., 1914.

[3] Best outlined in 27 I. C. C. Rep. 581. Cf. also Report to the Joint Board on the the Validation of Assets and Liabilities of the New York, New Haven and Hartford Railroad under Chapter 652, Acts of 1910, by George F. Swain, Engineer in Charge; published in Report of the Massachusetts Joint Commission on the New York, New Haven & Hartford Railroad Company, February 15, 1911, pp. 51–154. [Known as the Validation Report.] Other details concerning steamship lines are given in the above I. C. C. report, supplemented by the further testimony taken in May, 1914; also Report U. S. Bureau of Corporations on Transportation by Water, pt. 4, 1913, p. 17. The second extended I. C. C. Rep. has just been issued (July, 1914); I. C. C. Rep. 31.

railroad sphere, — that is to say in trolley companies, steamship lines and even electric light and power plants. A tale of more reckless disregard of the interests of the public and of investors alike, — a more complete breakdown of service in the form of intolerable losses and delays and appalling accidents, —has never been spread upon the records. It is an involved affair in entirety. We must be content to outline it by territorial samples.

The Connecticut trolleys in the New Haven system were originally leased as the Connecticut Railway and Lighting Company. This aggregation of roads had been formed by the consolidation of nine smaller concerns in 1900. Bonds to the amount of $9,350,000 and shares amounting to $15,000,000, — a total of $24,350,000, — were exchanged for a former combined capitalization of $8,210,000, at the time of consolidation.[1] This flagrant over-capitalization was characteristic of the general situation in that state. The absence of rigid governmental oversight, outside of Massachusetts, created a striking contrast in this regard, to which attention will be called in another connection. Where the New Haven Railroad agreed by purchase and lease to support this inflated capitalization, the operation practically, of course, amounted to dilution of the value of its own securities to a corresponding degree. The Massachusetts Validation Commission in 1911 found that, even making no allowance whatever for depreciation, $13,000,000 of a total par investment of $40,000,000 of the New Haven railroad in these Connecticut trolleys represented no tangible value whatever. Still less, apparently, did it represent earning power.

The roundabout processes by which the New Haven obtained control of its trolley lines in Rhode Island may

[1] Report of Commission *de* Public Service Corporations, Connecticut, 1909, pp. 8–11; New York Evening Post, Nov. 23, 1912.

best be described by direct quotation from the report of the Interstate Commerce Commission.[1]

" In 1902 the United Gas Improvement Company, generally understood to be an institution backed by Philadelphia capital, entered the trolley field in Rhode Island. A corporation known as the Rhode Island Company was organized which issued its capital stock in the sum of $2,000,000 to the Improvement Company, receiving in return $2,000,000 in cash. The Rhode Island Company thereupon leased three trolley lines, which embraced in the main all the lines in Providence, Pawtucket, and the immediate vicinity.

"The Improvement Company now proceeded to organize what was known as the Rhode Island Securities Company for the purpose of holding the stock of the Rhode Island Company. The Improvement Company turned over to the Securities Company the $2,000,000 of stock in the Rhode Island Company and received therefor without any further consideration $12,000,000 of the capital stock of the Securities Company and $3,500,000 of its 4 per cent bonds. This resulted in the issue to the Improvement Company of $15,500,000 of securities for $2,000,000 in money.

" This was in 1902. In 1904 the New Haven began its campaign for the acquisition of the trolley lines of southern New England, and soon after purchased a block of the stock of the Rhode Island Company. In 1906 it perfected arrangements for the acquisition of the entire stock of that company. Instead, however, of purchasing that stock directly, it arranged to do it indirectly by taking over the Securities Company. What the New Haven did was to organize a third corporation, the Providence Securities Company, which exchanged its 4 per cent debentures guaranteed by the New Haven Company for the stock, bonds, and notes of the Rhode Island Securities Company substantially at par. There was a cash payment of $10 per share by the stockholders of the Rhode Island Securities Company and an adjustment of $3 per share against this on account of interest; there were certain bookkeeping entries one way and the other, but the upshot of the whole transaction was that the New Haven Company issued its obligations to the Improvement Company and others and received in exchange at substantially dollar for dollar these inflated securities of the Rhode Island Company.

"Representatives of the New Haven Company earnestly insisted that this company had not watered the stock of the Rhode Island Company, and this, strictly speaking, is true. The improvement Company turned in the water and the New Haven Company converted that water into wine. In whatever aspect the transaction is viewed the New Haven gave $13,500,000 for nothing."

[1] 27 I. C. C. Rep. 581.

The net result of this operation was a total investment of about $24,000,000, altho the state authorities subsequently estimated the property to be worth only about one-fourth of this figure.[1] Nor were the earnings of these Rhode Island trolleys, at any time, sufficient to justify the prices which the New Haven paid for them. The reckless expenditure, in order to secure monopoly control, simply saddled the New Haven treasury with a huge aggregate of inflated securities which did not begin to cover the cost of raising the funds for their purchase.

The $13,500,000 given for nothing in the Rhode Island trolleys was well matched by the investment in the New York, Westchester & Boston Railway, — a four-track electric road, extending about twenty miles out from New York. This affords an instance of inflation, not only in connection with franchise purchase but also as a piece of original construction. Eight thousand shares of New Haven stock, worth $1,200,000, were first exchanged for 24,000 Westchester shares, worth in the words of President Mellen "about ten cents a pound." Then about $11,000,000 more was paid for $5,000,000 invested in construction by the promoters, — this by command of J. P. Morgan without any adequate accounting even to the directors. All in all, to 1912 the New Haven invested $35,000,000 in this enterprise; altho the value of tangible property, reported to the New York Public Service Commission, was only $12,000,000. An annual deficit of $1,250,000 still obtains.[2] While this was going on, the New Haven was also seeking the control of the Boston & Maine Railroad in order to consolidate its own transportation

[1] President Mellen himself on May 20, 1914 before the I. C. C. conceded that the price was twice their value.

[2] The Mass. Validation Report of 1911 accepted an inventory of $12,300,000 for plant and estimated $8,900,000, " for cost of the franchise, control of the situation, etc."

companies south of Boston with those of northern New England. The financial mechanism by which this was accomplished is described in another place. So far as inflation of capitalization is concerned, in order to elude the prohibitions of the legislature and the courts of Massachusetts, the Boston & Maine stock was for a brief period in 1908–09 sequestrated in the hands of one J. L. Billard. To him the stock was sold at $125 per share, within a few months to be once more returned to the New Haven company at $150 per share. "Upon the face of the transaction, therefore, Mr. Billard made, without the investment of a dollar in excess of all expenditures by him, slightly over $2,700,000 as a result of this transaction." [1] Moreover, the objection that this unearned paper profit was not an actual one, because the final payment was not in cash but in notes, was met by the significant fact that the notes given in connection with the final transfer were guaranteed as to face value by the New Haven Railroad Company. Upon the record, therefore, the cost to the New Haven company of these profitless transactions was almost $3,000,000, — a sum which, of course, was a part of the large amount which had to be raised by the issue of securities by the parent road.

Other minor instances of inflation under the Mellen administration may be mentioned in passing. Without any substantial new investment, the capitalization of the Portland Union Station Company was run up from $350,000 to almost $6,000,000 with entailed fixed charges of $180,000 a year. Even after public opinion had become thoroly bent upon subjecting the New Haven to control, the Western Trolley Merger bill was jammed through the Massachusetts legislature in 1913 as

[1] 27 I. C. C. Rep. 584. Corrobrated by testimony of Billard, May 7, and of Mellen, May 17, 1914, further elaborated in 31 I. C. C. Rep. 31.

the price of acquiescence by the railroad in the creation of a Public Service Commission. This permitted the acquisition of the stock of three voluntary associations which as holding companies controlled the trolley lines in western Massachusetts. This opened the door to the capitalization of $22,398,000 of floating debt, premiums on stock and other items, without let or hindrance by public authority.[1]

In conclusion, the Interstate Commerce Commission made it clear as a result of its elaborate investigation, that if the New Haven had confined itself exclusively to the operation of its railroad property, it would have had for the fiscal year 1912 a surplus of $1,794,000 over and above eight per cent dividends upon its stock, instead of a deficit of nearly $1,000,000. Matters went from bad to worse subsequent to this time. Shareholders with dismay witnessed a decline in the market price of New Haven stock from about $185 in 1905 to less than $50 per share in 1914. Dividends, after years of uninterrupted payment, had to be suspended during a wearisome period of recuperation. The dismal chapter seems about to be closed in 1914 by the resolution of the system into its component parts under compulsion from the Federal Department of Justice. The interest of the public appears in the fact that under other circumstances the railroad might conceivably have continued to furnish a safe and adequate service without further advance in its rates, and fares and yet at the same time have returned to its stockholders a fair dividend upon their investment.

(6) Financial reorganization offers a fruitful field for an increase of capitalization, irrespective of assets, whether for railroads or industrial corporations. Occa-

[1] Ann. Rep., Mass. Railroad com., 1912, pp. 167–175.

sionally a company succeeds in emerging therefrom with the same volume of outstanding securities with which it went into bankruptcy. By far the larger number come forth saddled with heavier issues than ever before. Even more impressive is the volume of securities by comparison with the assets. Almost never does any real excision under reorganization take place.[1] All this is, of course, highly paradoxical, inasmuch as it was the overload of stocks and bonds which brought on the trouble, — an overload so disproportionate to the earning power of the property that its back broke under the burden. But the explanation is not far to seek.[2] It is never the total capitalization of a company which is the source of danger. The volume of capital stock is immaterial. It is the fixed charges upon indebtedness to which the road succumbs. Some way must be discovered under reorganization by which the old bondholders may be induced to forego their right of foreclosure. This almost always happens through offering them securities in exchange like income bonds or preferred stock, contingent upon earnings for their support. But the consent of bondholders to such substitution is in any event difficult to obtain. The most inviting speculative bonuses, even in the form of a modicum of common stock, must be dangled before their eyes in order to obtain consent for the substitution. This is what is even now occurring in the pending reorganizations of the Wabash, the Rock Island, and the "Frisco," not to mention several minor roads.

It is a difficult and yet an important matter to control reorganization in the interest, not of particular classes of security holders but of the company as a whole and

[1] Simon Sterne, Forum, vol. x, p. 37; vol. xvii, p. 19.

[2] For a full discussion, I refer to my forthcoming volume on Railroad Finance and Organization.

the public to be served. Otherwise the readjustment may only make bad matters worse. An admirable example of the well-advised exercise of governmental control is afforded by the hard-fought controversy upon the Third Avenue Street Railroad in New York. The experience merits review. In 1907–08 this company went into the hands of receivers. Its financial history was a disheartening record of fraud. Stocks and bonds of subsidiary companies stood upon the books at a cost of $9,950,000 — nearly twice their face value — despite the fact that one of these companies was in the hands of a receiver, another was practically worthless, and none of them judged by earnings was conceivably worth more than par. Over $500,000 of capital had been devoted to paying interest charges; $6,000,000 had gone into operating expenses; $1,000,000 for lawyers' fees; $1,000,000 into an untraced construction account, while for $5,000,000 there was absolutely no record.

In 1909, after foreclosure proceedings, a reorganization committee of bondholders as intending purchasers prepared a plan for the organization of a new company and applied for authority to issue the necessary securities.[1] The plan of readjustment frankly admitted a huge discrepancy between the assets of the property and the capital liabilities proposed. The outstanding bonds and stock of the old Third Avenue road amounted to $58,560,000; the new capitalization was practically identical in amount. The plan followed the common rule in the reorganization of companies characterized by much watered stock and depreciated bonds. Fixed charges were cut down by substituting for the old mortgages, new income bonds calling for interest only as earned; and a heavy assessment was levied upon stock-

[1] 3 P. S. C., 1st D., 31.

holders under penalty of having their former holdings cancelled. The Public Service Commission upon this showing declined to permit the new company to be capitalized for an amount equal to the outstanding securities of the old road, alleging properly enough that the reorganization was an opportune time for bringing capitalization and assets more nearly into equivalence.

After this first rebuff, a somewhat improved plan of reorganization was in due time presented for approval. The stockholders, instead of being required, as before, to subscribe heavily to new stock equally valueless with the old, were now given a certain proportion of bonds in return for their assessment. But even under this second plan, the outstanding securities aggregated $73,600,000, whereas the physical assets were avowedly worth only $44,000,000. This excess of liabilities was, of course, the fruitage of the stock-watering and fraud of past years. Even on the basis of reproduction cost entirely new, plus necessary working capital, current assets amounted to only $68,000,000. This figure made no allowance for depreciation, obsolescence or inadequacy, and it included $11,625,000 for "development expenses," such as brokers' commissions and discount on bonds. The Public Service Commission thereupon in 1910 disallowed the second application. The case then went to the Supreme court and a decision was finally handed down,[1] purely on law points, which upheld the appeal of the reorganization committee. An ancient section of the Stock Corporation law was unearthed, which by oversight was not repealed when the Public Service Commission Act was passed. This gave free rein in the matter of recapitalization to reorganiza-

[1] N. Y. 145 App. Div. 318; 203 N. Y. 299; 96 N. E. Rep. 1012. Precedent followed by Nebraska; 5th Ann. Rep. Railroad Commission, 177.

tion managers. The next legislature promptly revised the statute. But in the meantime, the Commission was obliged to approve this second plan despite the utter discrepancy between capitalization and assets. But, of course, under such circumstances the new securities could not be marketed at anything like par. It was estimated that $55,000,000 par value would produce only about $33,000,000 in cash. At this point, the Commission in 1912 once more intervened.[1] The policy imposed was the only sound one for dealing with matters of this sort. It was directed that an amortization fund be set aside annually out of earnings, sufficient to cancel all the excess of liabilities over assets by 1960, when the bonds matured. Heavy depreciation charges were also required. A similar wholesome plan has since been adopted in the case of steam railroad issues by the New York up-state commission, notably in approving of the New York Central bond issue of $70,000,000 in 1914. Such may be said in fact to have become the established practice. It is obviously the only prudent one.

The foregoing review of experience is broadly significant. It emphasizes the need of governmental supervision in matters of finance, — certainly so far as standardization of accounts is concerned, and probably also as indicating the further need of downright control by administrative order.[1] But such supervision cannot be exercised by divided and conflicting state authority. The Federal government must certainly take hold. The need of so doing is still further emphasized by the proven inter-relation of rates, service and finance. Everything seems to point to the assumption of such control by the

[1] 3 P. S. C., 1st D., 51.

[2] Cases before state commissions will be analyzed by the author in the Economic Review, September, 1914.

Interstate Commerce Commission. It is no light matter to lay so heavy an additional burden upon this already over-worked body. The necessity of a separate departmental organization for this set of financial functions is clearly foreshadowed.

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